UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

San Diego Gas & Electric Company, Complainant, v. Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and the California Power Exchange, Respondents.	Docket Nos. EL00-95-004 EL00-95-005 EL00-95-019 EL00-95-031
Investigation of Practices of the California Independent System Operator Corporation and the California Power Exchange	Docket Nos. EL00-98-004 EL00-98-005 EL00-98-018 EL00-98-030
Puget Sound Energy, Inc. Complainant, v. All Jurisdictional Sellers of Energy and/or Capacity At Wholesale into Electric Energy and/or Capacity Markets in the Pacific Northwest, Including Parties to the Western Systems Power Pool Agreement, Respondents.	Docket Nos. EL01-10-000 EL01-10-001

REQUEST OF THE
CALIFORNIA ELECTRICITY OVERSIGHT BOARD
FOR EXPEDITED REHEARING OF THE
JULY 25 ORDER ESTABLISHING EVIDENTIARY HEARING PROCEDURES

Pursuant to Rule 713 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.713 (2000), and Section 313 of the Federal Power Act ("FPA"), 16 U.S.C. § 825l, the California Electricity Oversight Board ("CEOB") hereby seeks expedited rehearing of the Federal Energy Regulatory Commission's (Commission's) July 25, 2001, *Order Establishing Evidentiary Procedures, Granting Rehearing in Part, and Denying Rehearing in Part*, 96 FERC ¶ 61,120 (2001) ("July 25 Order").

In its July 25 Order, the Commission recognizes that refunds by wholesale electricity sellers must occur to adjust unjust and unreasonable prices charged during 2000 and 2001 back into the statutorily required zone of reasonableness required by the Federal Power Act (FPA). The July 25 Order sets forth guidance on how such refund calculations should occur. Unfortunately, the method directed by the Commission has several flaws that have the effect of insulating many transactions and unreasonable charges from redress. Consequently, the method as described in the Commission's July 25 Order is inadequate to fulfill the Commission's mandate to ensure that prices are held to just and reasonable levels.

The single most harmful error reflected in the July 25 Order is the decision by the Commission to exclude from any remedy those purchases made directly by the California Department of Water Resources (CDWR) in the spot market. This is particularly unjust because the Commission and wholesale sellers essentially forced CDWR into the bilateral market by eliminating the day-ahead market of the California Power Exchange (CalPX), by discouraging sales through the real-time imbalance energy spot market operated by the California Independent System Operator (CAISO) and by sellers' insistence upon dealing with CDWR directly once CDWR became the buyer of last resort for California's consumers.

The CEOB estimates that failure to include CDWR's bilateral spot purchases will cost California consumers two billion dollars excess unjust and unreasonable charges. The three other methodological errors will cost California's consumers hundreds of millions of dollars in excess unjust and unreasonable charges. The CEOB urges the Commission to correct these errors by issuing an expedited order on rehearing.

I. SPECIFICATION OF ERROR AND SUMMARY OF ARGUMENT

- ***The failure to include California Department of Water Resources (CDWR) bilateral "spot market" purchases within the scope of sellers' refund liability is an abuse of discretion.***

The Commission's own orders imposing an underscheduling penalty for transactions through the CAISO's real-time transactions and eliminating the day-ahead market of the CalPX forced CDWR, who became the purchaser of last resort on behalf of California consumers, to pursue bilateral transactions outside the formal markets operated by the CalPX and CAISO. Moreover, the July 25, Order is based on factual error. The Order states that CDWR chose not to purchase energy through the CAISO's real-time spot market.[1] In fact, sellers refused to sell through the CAISO and told CAISO traders looking to secure energy, that they would only deal directly with CDWR. Accordingly, the July 25 Order unreasonably ignores a massive quantity of spot transactions at extremely high prices tainted by market power that are the equivalent to other transactions that are subject to refund.

[1] As discussed below, the Commission relies on an unsworn statement filed by a group of generators that characterizes CDWR purchases as "bargained for exchanges between willing buyers and sellers . . . ." Not only is this statement unsworn and merely conclusory, in does not logically or factually entail that CDWR had the option to purchase through the CAISO but chose not to.

- ***The inclusion of a ten percent adder for credit risk is an abuse of discretion and is unduly discriminatory and without rational basis.***

  The Commission rationalized the ten percent adder as compensating for the risk of non-payment following the unsuccessful settlement negotiations in this proceeding. The July 25 Order also imposes interest on amounts found to be owed. Interest is the customary means to compensate for the time-value of money. The ten percent adder in addition to interest to compensate for the risk of non-payment is non-sensical and unfair. On the one hand, if sellers are not paid, then they will never realize the ten percent premium. On the other hand, if sellers are paid, they will receive full compensation for the time-value of any amount due, i.e. principal plus interest—adding an additional ten-percent is simply a gift and further increases the transfer of wealth from consumers to generators. Moreover, the Commission would impose the ten percent adder only on amounts owed by load serving entities rather than all parties to the failed settlement negotiations. In this proceeding, the parties' dispute involves the justness and reasonableness of rates; the Commission has found that sellers have charged unjust and reasonable rates; and sellers have reaped unheard of profits from California's consumers. To impose a further penalty on consumers would be an injustice and would violate the Commission's obligation to protect consumer interests.

- ***Utilizing the heat rate of the actual unit dispatched based on the bid price allows the past exercise of market power by physical or economic witholding to increase the proxy market clearing prices and is inconsistent with the Commission's marginal cost rationale.***

  The record demonstrates that sellers do not routinely bid their marginal costs. Thus, lower cost units that may have been physically available may not have been dispatched if they were bid at higher rates than less efficient units. By considering only the units that actually made themselves available and using the heat rate of the last unit that should have been dispatched, the proxy market clearing prices will better reflect marginal cost pricing. To do otherwise, will retroactively validate noncompetitive bidding and economic withholding. The CAISO's analysis presented at the settlement conference in this proceeding is based on the appropriate methodology and does not, as the Commission states, assume all units were actually available. The CAISO's methodology should, therefore, be used to calculate the proxy market clearing prices.

- ***The Commission's use of daily spot gas prices in the calculation of the refund market-clearing price is unsupported by the record and, therefore, is arbitrary and capricious*.**[2]

  In fact, there is no record evidence that *all* "energy sales were made with spot gas purchases." Natural gas costs should be based on actual costs, which should be readily determinable. Those sellers, including Reliant—the *only* seller offering testimony on the record that it purchased natural gas on the spot market—that did

[2] The CEOB raises these specifications of error on an expedited basis. The CEOB does not thereby waive its right to seek timely rehearing, or judicial review as appropriate, on other issues raised in the July 25 Order.

purchase gas on the spot market will have those costs reflected in the proxy prices established for their units.

II. ARGUMENT

A. The Failure To Include California Department Of Water Resources (CDWR) Bilateral "Spot Market" Purchases Within The Scope Of Sellers' Refund Liability Is An Abuse Of Discretion

By motion dated March 1, 2001, the CEOB requested clarification and/or extension of the December 15, 2000 *Order Directing Remedies for California Wholesale Electric Markets*, 93 FERC ¶ 61,294 (2000) (December 15 Order) to include CDWR purchases. In this motion, the CEOB requested that the Commission include CDWR bilateral energy transactions within the scope of the December 15 Order's mitigation scheme thereby making these transactions subject to refund from October 2, 2000, the refund effective date established in the Commission's November 1, 2001 *Order Proposing Remedies for California Wholesale Electric Markets*, 93 FERC ¶ 61,121 (2000) (November 1 Order). In its July 25 Order, the Commission denied the CEOB's motion. July 25 Order, *slip op.* at 29.

The Commission also ordered an evidentiary hearing to determine refunds for CalPX and CAISO transactions from October 2, 2000 through June 20, 2001. This evidentiary hearing is to conclude within 60 days of the July 25 Order (or by September 22, 2001) with the Administrative Law Judge's certified finding of facts. July 25 Order, *slip op.* at 37-38. Thus, the hearing will likely begin in less than two weeks from the date of this request for expedited rehearing. Accordingly, the CEOB seeks expedited consideration so that, in the event the Commission orders rehearing as requested, the evidentiary hearing can include the CDWR spot purchases[3] and the other modifications to the refund formula discussed herein.

1. CDWR Had No Choice But To Deal With Sellers Directly For Spot Market Purchases

The Commission's decision excluding CDWR transactions appears to rest, in part, on the notion that CDWR deliberately chose not to buy through the available mitigated markets operated by the CAISO and CalPX. The July 25 Order states: "[B]y voluntarily entering into bilateral transactions outside the ISO and PX, DWR made a conscious decision to forego the refund protection that the Commission provided for purchases through the ISO and PX." July 25 Order, *slip op.* at 29. This is simply not true. Nor is there evidence on the record that would support this conclusion.

CDWR became the purchaser of last resort for California's consumers on January 18, 2001. By then, the CalPX was in its death throes as a result of the December 15 Order which terminated the CalPX's tariff and barred California's two large load serving utilities, which were at or near bankruptcy, from scheduling or purchasing any energy other than from resources that they owned or controlled. December 15 Order, 93 FERC ¶ 61,294 at 61,982. The December 15 Order also imposed a penalty (two-times the cost of energy not to exceed $100/MWh) on purchases through the CAISO's real-time imbalance energy market in excess of five percent of the total amount of energy needed to serve the purchaser's load. *Id*. at 61,982, 61,002. While the Commission's mitigation measures

[3] The CEOB's March 1, 2000 motion requested that all CDWR transactions be included in the Commission's mitigation plan. This request for rehearing relates only to CDWR's spot purchases as defined in the Commission's July 25 Order.

were no doubt well intentioned,[4] the consequences of these measures placed CDWR between a rock and a hard place.

When CDWR began purchasing electricity, in response to Governor Davis's emergency executive orders and emergency legislation passed by the California legislature, it became immediately responsible for purchasing the "net-short" needs of California's economically distressed utilities. The "net short" is defined as the difference between the expected demand of the utilities' load and the amount of supply owned or controlled by the utilities (which the utilities would schedule directly with the CAISO). The net-short amounts have ranged, since March 1, 2001, between 29 and 49 percent of the utilities' load and CDWR has had to purchase a large percentage of the net-short in the spot market.[5]

CDWR had little choice but to purchase in the spot market. First, although the December 15 Order terminated the CalPX tariff as of April 30, 2001, the effects of the December 15 Order on the CalPX were immediate resulting in drastic reductions of volume that forced the CalPX to close its doors on January 31, 2001. Consequently, one of the mitigated markets intended to protect California consumers and in which transactions were subject to refund pursuant to the December 15 Order was simply not available to CDWR.

---

[4] The December 15 Order was the first decision in this proceeding in which the Commission ordered mitigation measures in an effort to address California's broken wholesale electricity market. By terminating the CalPX tariff, the Commission hoped California's utilities would have more flexibility to purchase energy on behalf of consumers. In fact, the utilities had less flexibility. The underscheduling penalty was intended to make the CAISO's'real-time imbalance energy market less attractive to encourage longer term purchases and advance scheduling of a greater percentage of energy needed to serve load. Unfortunately, underscheduling was not reduced and the Commission's penalty has simply raised the price of doing business in the CAISO's real-time imbalance energy market. Each of these measures had backfired as discussed in other pleadings filed by the CEOB in this proceeding.

[5] See Table 1 below.

Second, the Commission itself discouraged use of the CAISO's real-time energy spot market by imposing a stiff penalty.   The Commission's intention was to discourage spot market purchases and to encourage longer term contracting. Nevertheless, CDWR had little choice but to purchase needed energy on the spot market to maintain the reliability of the system as it has taken months to negotiate longer term contracts and much of the supply now under long term contract is for future deliver.[6]

Third, and most important, the Commission commits error by assuming the CAISO's mitigated real-time energy market was, in fact, available to CDWR. As set forth in the Declaration of James Detmers, Vice President of Grid Operations of the CAISO attached as Exhibit A, filed and served herewith, sellers have refused to offer supply into the CAISO's real-time energy market. Declaration at 4. In instances where insufficient capacity was being offered into the CAISO's real-time imbalance energy market which caused CAISO traders to seek out-of-market (OOM) purchases (i.e. purchases outside of the CAISO's real-time imbalance energy market), sellers informed CAISO traders that they would not offer supply into the CAISO's real-time energy market or offer OOM energy to the CAISO, but some sellers indicated that they would be willing to sell to CDWR directly. *Id.* Thus, one very important "fact" the Commission relies on—that CDWR could have but chose not to buy energy through the CAISO's real-time imbalance energy market—is not true.

In addition, the Commission appears to infer the "fact" that CDWR deliberately chose not to purchase electricity through the CAISO's mitigated market from a statement

---

[6] The CEOB, among others, sought rehearing on the underscheduling penalty. Thus far, the Commission has declined to terminate this penalty.

in a filing by a group of generators made as a comment to Judge Wagner on July 9, 2001 following the 15-day settlement conference held in these proceedings. In arguing that CDWR transactions should not be included within the scope of the refund order, the generators state: "[T]hese [CDWR] transactions represent bargained-for exchanges between willing buyers and sellers (with CDWR picking and choosing the transactions it wanted, exercising discretion and exhibiting price response)." Statement of Undersigned Generators to the Chief Judge (July 9, 2001) at 8. The Commission's conclusion of fact that CDWR chose not to purchase through the CAISO does not logically follow from the quoted statement.

First, the statement is not even directed to the question of CDWR's option to purchase through the CAISO real-time imbalance energy market. The statement simply asserts that CDWR shopped OOM. Nor is the statement even directed to spot market purchases. In fact, CDWR has negotiated a large number of long-term contracts that would not be subject to mitigation.

Second, the quoted statement is in a very conclusory form, the kind of conclusion that can only be drawn from evidence relating to the transactions themselves, which is not on the record. Third, the statement is argument, it is not offered in the form of evidence, i.e. as testimony offered under penalty of perjury. Clearly, the record—even without the Detmers Declaration—cannot support the conclusion that CDWR had the option to purchase through the CAISO's mitigated market and chose deliberately not to.

2. CDWR's Bilateral Spot Market Purchases Were Made Under Exactly the Same Conditions As The CAISO's Out-Of-Market Purchases That Are Subject To Refund

The July 25 Order clarifies that the CAISO's OOM purchases are subject to refund. This conclusion is fully consistent with the Commission's December 15 Order as follows:

> Our finding that the California market structure and rules provide the opportunity for sellers to exercise market power when supply is tight requires us either to reject or to *condition the market-based rates of all sellers into the markets operated by the CAISO and the CalPX* for an interim period. We conclude that conditioning will provide the best means of addressing the market dysfunctions in California." [December 15, 2000 Order, 93 FERC 62,011 (emphasis added)].

The December 15 Order did not limit refunds to sales through the CAISO or CalPX, but conditioned rates of sellers who operated in those markets. Most, if not all, of CDWR's spot market purchases are from the very same sellers who had been operating in the CAISO's and CalPX's markets and who also sold to OOM energy to the CAISO.

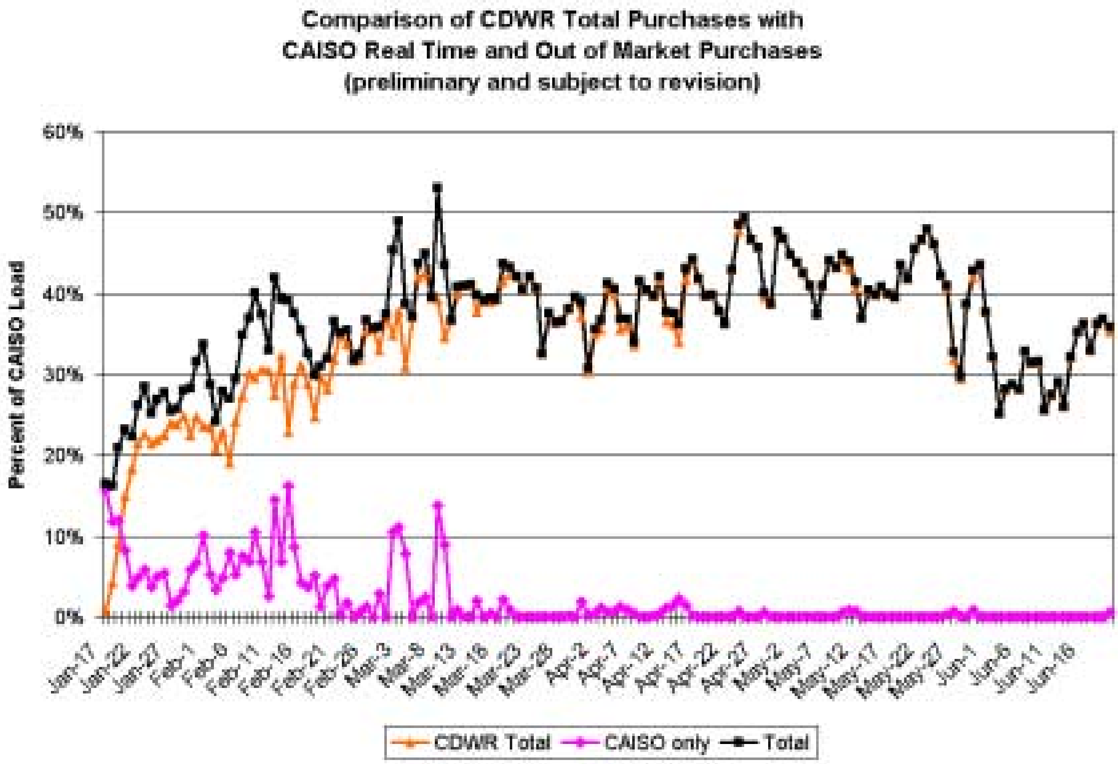
More importantly, the justification for including OOM transactions applies just as well to CDWR's spot market purchases. The July 25 Order quotes extensively from the Commission's November 1, Order, in particular that the "entire market structure and rules for wholesale sales of electric energy in California are flawed and [ ] these structures and rules, in conjunction with an imbalance of supply and demand in California, have caused, and continue to have the potential to cause, unjust and unreasonable rates for short-term energy . . . ." July 25 Order, *slip op*. at 29-30 (quoting the November 1 Order, 93 FERC at 61,349). The July 25 Order further quotes from the November 1 Order" that the "California market structure and rules provide the opportunity for sellers to exercise market power when supply is tight and can result in unjust and unreasonable rates under the FPA." *Id*. at 30 (quoting the November 1 Order, 93 FERC at 61,350). In its July 25 Order, the Commission finds that: "*These statements [from the November 1 Order] are* *most true with respect to the ISO's daily OOM purchases for obtaining the resources it needs to reliably operate the grid." Id* (emphasis added).

The Commission goes on to explain that

> As stated in the August 23 Order, if there is insufficient supply in the ISO markets, then the ISO must procure additional supplies at the last minute with OOM purchases in order to meet its needs for the operating day. Historically, the ISO procured on a daily basis only the resources needed for the operating day. Not only did this procurement practice put pressure on the grid operator to secure needed resources at the last minute, but the practice was uneconomical***. Because the ISO is the supplier of last resort for these services, when OOM calls are made, suppliers realize that the ISO is in a must-buy situation.*** . . .
>
> ***To the extent the ISO made spot market OOM purchases (i.e., 24 hours or less and that were entered into the day of or day prior to delivery), such purchases are no different than purchases through its markets. Both types of purchases are made by the ISO in order to procure the resources necessary to reliably operate the grid.*** Therefore, we clarify that spot market OOM transactions are subject to refund and subject to the hourly mitigated price established in the ordered hearing. The hourly price will establish the maximum price with refunds for transactions over this level.

Id. (emphasis added).

CDWR was forced to assume precisely the role described above: buying to keep the lights on in California in the spot market. Indeed, the CAISO real-time market and the CAISO's OOM purchases fell off dramatically after CDWR assumed responsibility as the purchase or last resort and had to buy similar amounts of energy within 24 hours of deliver to maintain the reliability of the system as seen in Table 1 below:



Finally, the prices CDWR has been forced to pay for spot purchases have been individually and on average extremely high. According to CDWR, it spent $5,189,611,640 for spot market purchases from January 18, 2001 through May 31, 2001.[7] This is out of total energy and ancillary services expenditures of $7,650,942,762.[8] Thus, fully 68 percent of CDWR's purchases were made on the spot market.

The average spot price through this same period was $295/Wh ($321 in January, $308 in February, $271 in March, $332 in April and $271 in May).[9] More significantly,

[7] California Department of Water Resources Activities and Expenditures Report January 18, 2001-May 31, 2001 (July 9, 2001) at 9. CDWR defines the "spot market" as "day-ahead purchases, hour-ahead purchases and ISO real-time purchases." *Id*. at 7.
[8] *Id.*
[9] *Id.*

many transactions were substantially above the average. Below the CEOB offers just few examples of outrageously high prices from January 2001 in Table 2 below:[10]

Seller	Date	Price per MWh	MWhs	Total price
American Electric Power	January[11]	$ 450	10,530	$ 4,759,325
Avista	January	$ 450	100	$ 45,000
Coral Energy	1/28/01	$ 643.75	800	$ 515,000
Coral Energy	1/29/01	$ 563.82	2,700	$ 1,582,050
Powerex	January	$ 895.65[12]	23,000	$ 20,600,000
Williams	January	$ 400.00	500	$ 200,000

3. CDWR Did Not Obtain Any Competitive Advantage When It Assumed Its Purchasing Obligations

Another reason offered by the Commission as a basis for not including CDWR purchases within the scope of the refund hearing is that because CDWR "had access to the ISO's control room and associated written materials, visual observations, and oral statements regarding the ISO's markets, systems, operations and activities," CDWR had a "competitive advantage in entering its bilateral contracts." July 25 Order at 29. Whatever information CDWR obtained as a result of contact with the CAISO, it is nothing more than what the CAISO had available for its own use when it operates its real-time energy imbalance spot market or when it buys energy directly from suppliers in an OOM transaction when the CAISO was the buyer of last resort. Accordingly, when CDWR assumed its role as buyer of last resort, it had no more tools than the CAISO. Clearly, the CDWR had no competitive advantage compared to the CAISO.

[10] The information in this table is obtained from copies of invoices of spot market purchases from January 17, 2001 through May 31, 2001 released by CDWR on July 9, 2001.
[11] Delivery month indicated when specific delivery dates not included on invoice.
[12] This is the average price charged by Powerex for January transactions. The vast majority of Powerex's sales were made at the rate of $1,000 per MWh.

Whatever advantage CDWR is afforded via information gleaned from the CAISO, it is not a competitive advantage over the sellers. Arguably, CDWR might have superior information about systems needs and conditions than other buyers. However, there is no other buyer in the role of buyer of last resort. More importantly, this proceeding concerns the justness and reasonableness of rates charged by sellers. Whatever advantage CDWR may have, if any, is entirely irrelevant to this proceeding.

B. The Inclusion Of A Ten Percent Adder For Credit Risk Is An Abuse Of Discretion And Is Unduly Discriminatory And Without Rational Basis

The July 25 Order includes a ten percent creditworthiness adder in the methodology to determine the competitive market price against which to calculate the refund liability of electricity sellers. July 25 Order, *slip. op*. at 36. The Commission justified imposition of the creditworthiness adder on the sole basis that:

> One result of the parties' failure to reach settlement in this proceeding is that payment of overdue amounts has not been assured. The methodology we set forth will determine the just and reasonable rates that buyers will pay, but it cannot provide assurances that buyers, one of which is currently embroiled in bankruptcy proceedings, will pay the full amounts due. [*Id*.]

The Commission's rationale for the creditworthiness adder is both illogical and unfair, and cannot lawfully be retained in the refund methodology.

1. The Creditworthiness Adder Is Redundant As The Order Awards Interest And Therefore Constitutes An Unnecessary And Unjust Windfall To Sellers.

Contrary to the Commission's express belief, the creditworthiness adder does not, and cannot, assure repayment of amounts owed. It does not, for instance, in any manner collateralize or provide security for prior electric energy transactions. Instead, the adder merely decreases the total refund liability as compensation for a purported risk of non-payment of offsets, if any, found owing to energy suppliers. However, this function is redundant of the interest provisions of the July 25 Order. "The purpose of prejudgment interest is to make the plaintiff whole by repayment of interest for loss of use of the money to which the plaintiff was entitled." *Woolard v. JLG Industries, Inc.*, 210 F.3d 1158 (10th Cir. 2000). Interest, not the creditworthiness adder, makes an aggrieved party "whole" by compensating for the time-value of money. Indeed, in the event of nonpayment, sellers will never realize the ten percent adder. In contrast, if repayment is made, no matter how delayed, sellers will receive full compensation, i.e., principal plus interest. Thus, adding ten-percent to the amount allowed for past sales simply constitutes an unnecessary windfall above prices deemed just and reasonable and increases the transfer of wealth from consumers to generators.

2. The Creditworthiness Adder Discriminates Against Load Serving Entities And Unreasonably Applies To All Purchasers Regardless Of The Existence Of Credit Risk.

The Commission's rationale further manifests an indefensible bias. The creditworthiness adder is imposed only on amounts owed by load serving entities. Implicit in this methodology is the Commission's conclusion that the responsibility for the failure of settlement negotiations lies exclusively with those parties representing load. This conclusion is wholly unjustified and unsupported by the record. More troubling, the creditworthy adder indiscriminately, and without any rational justification, punishes all load serving entities regardless of their credit risk. For instance, San Diego Gas & Electric Company ("SDG&E") and CDWR have fully satisfied their obligations. Yet, under the July 25 Order, customers served by SDG&E and CDWR purchases cannot recover the full amount of unjust and unreasonable overcharges by sellers despite the nonexistence of any material credit risk. This proceeding involves the parties' dispute as to the justness and reasonableness of rates. The Commission has found that sellers charged unjust and reasonable rates and, in so doing, have reaped unheard of profits from California's consumers. To impose a further penalty on consumers would be an injustice and would violate the Commission's obligation to protect consumer interests. *City of Detroit v. Federal Power Commission*, 230 F.2d 810, 816 (D.C. Cir. 1956) ("basic purpose of the [Federal Power Act] to protect consumers from excessive rates ….").

3. Application Of The Creditworthiness Adder Is Internally Inconsistent.

The July 25 Order expressly limits the creditworthiness adder "to all transactions that occurred after the downgrade of SoCal Edison and PG&E's bond rating on January 5, 2001." July 25 Order, *slip. op*. at 36. Carving out transactions prior to January 5, 2001, makes sense. Prior to the bond rating downgrade, there was no cognizable credit risk of selling into the PX or CAISO markets because the California utilities maintained an "Approved Credit Rating," as defined under the CAISO Tariff.[13] The Commission, however, disregards its own reasoning by ignoring that as of January 17, 2001, or, at a minimum, by April 13, 2001, all material credit risk related to CAISO markets were resolved through the combination of Commission orders imposing creditworthiness standards and the willingness of the CDWR to act as a counterparty for CAISO energy transactions.

On January 17, 2001, in response to the state of emergency proclaimed by Governor Davis, the CDWR assumed responsibility to purchase net short electricity on behalf of customers of certain California's utilities. On February 14, 2001, the Commission insisted that a creditworthy buyer be available for "scheduled" transactions to supply customers of California's investor-owned utilities involving third-party generators. *Order Addressing Creditworthiness Tariff Provisions Proposed by the California Independent System Operator Corporation,* 94 FERC ¶ 61,132 (2001) (February 14 Order).

[13] See, CAISO Tariff, Appendix A at 304.

The February 14 Order provided, however, that the Commission would allow the CAISO to excuse the California utilities from posting security for third-party transactions if appropriate credit-support arrangements were made. The February 14 Order implicitly acknowledged that purchases by the CDWR provided sufficient credit support. On April 6, 2001, the Commission clarified that its requirement for a creditworthy counterparty applied to all power supplied to serve the load of California's investor-owned utilities, including real-time transactions and transactions resulting from CAISO emergency dispatch instructions. *Order Granting Motion*, 95 FERC ¶ 61,026 (2001) ("April 6 Order")

The CAISO has, and is, complying with the Commission's directives and so advised market participants in its April 13, 2001 "Market Notice re Credit Issues." The April 13 Market Notice provided in pertinent part:

> To the extent (and only to the extent) that a purchase is not otherwise paid by any party or payable by another party meeting the credit standards set forth in the ISO Tariff (another "Qualified Party"), DWR will assume financial responsibility for all purchases by the ISO in its ancillary services and imbalance energy markets based on bids or other offers determined to be reasonable. … Unless a supplier is otherwise notified, any bid accepted by the ISO will be deemed to have the financial support of another Qualified Party of DWR as specified in this notice. In addition to the foregoing, DWR will assume financial responsibility for all purchases resulting from the issuance by the ISO of emergency dispatch instructions, to the extent not paid or payable by another Qualified Party.

Accordingly, the CDWR assumed the role of purchasing electricity to meet the "net short" demand of California's utilities as of January 17, 2001. The CDWR is a creditworthy purchaser. Other wholesale electricity purchasers, such as municipal utilities, also have been, and continue to be, creditworthy. In fact, the CAISO has confirmed that it “has not entered into any real time transaction unless a creditworthy party has provided assurance of payment.”[14]

Given the successful elimination of credit risk for transactions in CAISO markets by January 17, 2001, or, at a minimum, by April 13, 2001, the ten percent creditworthiness adder is redundant and inherently inconsistent. The Commission’s creditworthiness orders eliminated the effects on suppliers of the financial crisis that faced California’s utilities. Retention of the ten percent adder, therefore, will inappropriately compensate generators for credit risk that has been eliminated. Accordingly, no justification exists for the ten percent surcharge and its implementation is arbitrary and capricious and cannot be supported by the record compiled in this proceeding.

C. Utilizing The Heat Rate Of The Actual Unit Dispatched Based On The Bid Price Allows The Past Exercise Of Market Power By Physical Or Economic Witholding To Increase The Proxy Market Clearing Prices And Is Inconsistent With The Commission’s Marginal Cost Rationale

The July 25 Order ostensibly seeks to remedy the damage inflicted on California consumers by the unjust and unreasonable rates exacted by suppliers into California’s dysfunctional electric wholesale markets. To accomplish this goal, the Commission adopts a refund methodology that purports to emulate a competitive market. In a truly competitive market sellers will bid all available capacity at each unit’s marginal cost of

[14] Declaration of James W. Detmers, attached as Exhibit D to the Answer of the California Independent System Operator Corporation to Motion for Enforcement of the Orders of the Federal Energy Regulatory Commission of Southern California Edison Company, Docket Nos. ER01-889-005, et al. (June 22, 2001) (“CAISO Answer”). The CEOB respectfully incorporates fully herein by reference the CAISO Answer, pursuant to Rule 508(c) of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.508(c).

production and sellers will receive a market-clearing price based on the least efficient generating unit, i.e., with the highest heat rate, dispatched.

The July 25 Order fails to comply with its own theoretical foundation. Rather than assume that all units were bid into the California market, the July 25 Order instead calculates the market-clearing prices for refund purposes based on the heat rate of the last generating unit actually dispatched. By relying on the heat rate of the units actually dispatched, the Commission ignores the uncontroverted evidence in the record that suppliers exercised market power in California through both economic and physical withholding of generation resources.[15] The effect of economic or physical withholding is to prevent lower cost, or more efficient, resources from being dispatched to supply demand in order to set a higher market clearing price. Thus, the use the heat rates of the actual units dispatched effectively rewards generators for their exercise of market power.

The CEOB is not asking the Commission to construct an artificial market by assuming the must-offer requirement embodied in the June 19 Order had been in effect as of October 2, 2000 or by assuming that all resources were physically available. The CEOB is requesting that the Commission consider the heat rates of all units that had made themselves physically available (i.e. those units that actually made themselves available to the CAISO). The CAISO Tariff requires that all generators that had signed a Participating Generator Agreement to inform the CAISO of any forced or scheduled

[15] See, *e.g.*, *Empirical Evidence of Strategic Bidding California ISO Real-time Market,* Attachment C to *Comments of the CAISO on Staff's Recommendation on Prospective Market Monitoring and Mitigation for the California Wholesale Electric Power Markets,* filed in Docket Nos. EL00-95-012, et al. (March 22, 2001) ("Strategic Bidding Study"). The behavior of bidding above marginal cost is called economic withholding, and the action of not bidding or scheduling available resources in the market is called physical withholding. The Strategic Bidding Study concluded that with respect to five large in-state generators, economic withholding strategies were employed in approximately 60% of the generators' bids. Physical withholding strategies infected approximately 30% of the generators' bids. *Id.* at 9.

outages.[16] Accordingly, all generators who did not provide such notice and/or which actually bid into the CAISO markets (regardless of whether the bids were actually accepted) would be considered to be physically available. Thus, the heat rates of the units that were not, but could have been, dispatched should be considered along with the heat rates of the units that were dispatched in setting the proxy market clearing price as if these units were dispatched in economic merit order.

Such methodology would account for economic withholding, while avoiding the protracted factual investigation associated with verifying the validity of any claimed forced outage related to physical withholding. Thus, by considering only the units that actually made themselves available and using the heat rate of the last unit that should have been dispatched, the proxy market clearing prices will better reflect marginal cost pricing and the Commission's stated goal of emulating a competitive market. This is precisely the methodology used by the CAISO's expert economist, Eric Hildebrandt in the presentation presented at the beginning of the settlement discussions in this proceeding.

D. The Commission's Use Of Daily Spot Gas Prices In The Calculation Of The Refund Market-Clearing Price Is Unsupported By The Record And, Therefore, Is Arbitrary And Capricious

The July 25 Order proposes to utilize the daily spot market price for natural gas in calculating the refund proxy-price. In reaching this conclusion, the Commission adopts the Chief Judge's recommendation that purportedly "relied on record evidence that the energy sales at issue were made with spot gas purchases." July 25 Order, *slip*. op. at 34. The "record evidence," however, does not support the Commission's sweeping finding

[16] California Independent System Operator Corporation, FERC Electric Tariff, First Replacement Volume

nor can it justify substituting hypothetical gas purchasing behavior for actual, easily attainable cost data.

The Chief Judge's recommendation rested on two cursory and generalized paragraphs of testimony from John Stout of Reliant Energy.[17] In its entirety, that testimony is as follows:

> But it [use of bid week monthly price index] distorts the results below the actual cost of the people who are producing the power. The first issue is the fact that the use of bid week monthly index price does match the way most people buy gas for transactions in the spot markets. As I mentioned before, prudent risk management requires that if you're going to sell into a long-term market, you might buy monthly gas or long-term gas.
>
> But if your selling into a spot market where you don't know from day to day exactly how much gas you need or when you're going to need it, it's impossible to arrange that gas on a month-ahead basis. Instead, you basically have to get that gas as you're dispatched by the ISO. Therefore, you're buying it at daily spot prices, not month-ahead index prices.[18]

Mr. Stout discusses gas procurement in the abstract. He does not purport to describe how his own company, Reliant, purchases natural gas for generating purposes, let alone how each market participant structures its gas portfolio. In fact, Mr. Stout could not. As the Commission is well aware, the natural gas purchasing behavior of electric energy suppliers will vary, in part, on the each market participant's risk tolerance, its

No. II, Outage Coordination Protocols, 6.1 and 6.2.

[17] *Report and Recommendation of Chief Judge and Certification of Record*, 96 FERC ¶ 63,007, *slip op.* at 6 (July 12, 2001) ("The public record also indicates that spot energy sales in the CAISO's markets are made with spot gas purchases (Tr. at 601).").

[18] Transcript of July 9, 2001 Hearing, held in Washington, D.C. re San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services into Markets Operated by the California Independent System Operator Corporation and the California Power Exchange, under Docket No. EL00-95 et al., Vol. 12, p. 601.

prediction on trends in the natural gas market, and its the relationship with natural gas marketers, including whether or not that natural gas marketer is an affiliate. For example, Reliant, which does not have a "tolling agreement" with a natural gas marketer may very well purchase gas on the spot market to cover electric generation sold into spot markets. However, the same behavior cannot be extrapolated to those generators with tolling agreements. Tolling agreements, such as that between Williams and AES, for instance, generally grant to an entity the exclusive right to market the output of an electrical generating unit in return for supplying the generating unit with its natural gas requirements.[19] This allows the gas marketer to examine its entire gas portfolio, and market trends for both natural gas and electricity, to determine whether to dispatch electrical generating unit. Under such circumstances, it is unlikely that the gas marketer universally relies on the daily spot gas market to produce electricity sold in the spot market.

Commissioner Massey recognized the disconnect between the purported "record evidence" and the Commission's acceptance of an industry-wide gas procurement standard. "It is simply not clear to me that generators purchased gas at those spot prices to replace the gas used to generate electricity for sale into spot markets." July 25 Order, Massey Dissent, *slip. op*. at 3.

More importantly, Commissioner Massey acknowledged that there is no rational basis to rely on a hypothetical recreation of generators' gas purchasing behavior; we have historical data.

---

[19] See, Capacity Sale and Tolling Agreement filed in Docket Nos. ER98-2184-004, ER98-2185-004 and ER98-2186-004.

> And we do not have to guess at whether they did or not [purchase on the spot market]. We are dealing with an historical locked in period for which expenses are known or knowable. During that period, we can use actual fuel costs to determine the just and reasonable price, and we should do so. … We are not trying to influence future behavior in this order, but instead are determining just and reasonable prices for past periods and refunds for customers. We should use the most accurate data we have, and that is actual fuel costs. [*Id.*]

Indeed, the Commission's reliance on the imprecise and general nature of Mr. Stout's testimony suggests an unfortunate tolerance for hypothetical data inputs to the refund methodology depending solely on whether the assumption will benefit generators or consumers. On the one hand, the Commission flatly refused to "recreate the market[]" by identifying heat rates based on an assumed economic dispatch of physically available generating units. The Commission noted that "generators actually dispatched have specific marginal costs that are reasonably recover[able]" and that "using an assumed economic dispatch … unfairly punishes" generators. July 25 Order, *slip. op*. at 34.

On the other hand, the Commission punishes California consumers by not "recreating" generators' gas purchasing behavior. By using daily spot market prices, the Commission has inflated, without sufficient evidentiary support, the gas component of generators' marginal costs. The only beneficiaries of such inflation are the generators. Use of actual cost data, in contrast, is accurate and favors no set of interests.[20]

---

[20] The CEOB is being wholly consistent by advocating the use of actual gas cost data, while seeking modification of the Commission's use of heat rates for the actual units dispatched. The request to modify the relevant heat rate inputs follows from the manipulation of, and deviation from, competitive markets by generators through the well-documented exercise of market power in the form of physical and economic withholding. In the absence of such behavior, the heat-rate data for units actually dispatched would more closely parallel the data produced by a competitive market. In contrast, notwithstanding the incentives to maximize gas costs to justify bids above the breakpoint established in the December 15 Order, it can be assumed that all generators acted to minimize gas supply costs.

III. CONCLUSION

The CEOB has demonstrated that law and equity require the inclusion of CDWR spot market purchases in the refund proceeding. The CEOB urges the Commission to consider this request for rehearing on an expedited basis so that CDWR transactions can be considered among like transactions in the evidentiary hearing to be held in the near future before Judge Birchman.

Dated: July 30, 2001

Respectfully submitted,

ERIK N. SALTMARSH
SIDNEY MANNHEIM JUBIEN
GRANT ROSENBLUM

By: ______________________________

Sidney Mannheim Jubien
Senior Staff Counsel
California Electricity Oversight Board
770 L Street, Suite 1250
Sacramento, CA 95616
916.322.8601

Attorneys for the California Electricity Oversight Board

CERTIFICATE OF SERVICE

I hereby certify that I have caused the foregoing document to be served upon each person designated on the official service lists compiled by the Secretary for these proceedings on or before July 31, 2001, pursuant to Rule 2010(a) of the Commission's Rules of Practice and Procedure.

Dated at Sacramento, California, this 30th day of July, 2001.

____

Larry Cook
Electricity Oversight Board
770 L Street, Suite 1250
Sacramento, CA 95814
(916) 322-8601